
FRBSF WEEKLY LETTER

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The Economy in 1989: On Track

The following is a modified text of the luncheon address given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, before a group of business leaders and legislators in Salem, Oregon, on April 6, 1989. In this speech, President Parry discusses inflationary pressures, monetary policy, and the prospects for continued economic expansion through the end of 1989 and into 1990.

The U.S. economy in perspective

The current expansion is now in its seventh year—a record for all peacetime expansions. But just because it has been sustained this long does not necessarily increase the chances that it will end soon. On the contrary, the pace of nonfarm payroll job creation remains strong, with an average of close to 295,000 new jobs a month added in the first quarter.

No wonder the civilian unemployment rate dropped to five percent in March. That is a 15-year low. Factories are running at nearly 85 percent of capacity—the highest since the late 1970s. And the output of goods and services rose at a very strong 3½ percent rate last year, if you ignore the effects of the drought. Finally, until very recently, inflation of consumer prices was averaging about 4¼ percent—too high for the economy's long-run well-being, but well below the seven-percent average rate during the 1970s.

Stress points

All in all, this is hardly a picture of an economy with problems. But there is cause for concern, because of the three "D-words." "D" for deficits: the federal budget deficit that continues to hover around \$150 billion; the private saving deficit, or shortfall, that is generated by an abysmally low personal saving rate, which averaged only 4.1 percent in 1988; and the foreign trade deficit that has improved in recent years, but remains huge, at more than \$135 billion in 1988.

The implications of these deficits are not encouraging. First, the U.S. is spending beyond

its means and borrowing from abroad to do so. This, in turn, means that foreign investors hold a sizable lien on our future. And because we are using the borrowed funds primarily for consumption and government spending, rather than for investment in a major expansion of productive capacity, we will be forced to cut future living standards to pay off this debt.

As if those concerns are not bad enough, this "living beyond our means" also increases inflationary pressures. Warning signals have been flashing for some time now. For example, the very low unemployment rate and the high capacity utilization rate both suggest that the economy has been—and still is—operating at a level of activity that cannot be sustained without a pick up in inflation.

So, it is not surprising that virtually all the price indexes are giving up hard-fought ground now. In March, consumer prices were up five percent, compared to their level a year ago. Producer prices were up even more—nearly 5½ percent over the same period.

But what is really of concern is the rise in underlying wage inflation. Wages and benefits, as measured by the Employment Cost Index, rose at a 4.6 percent clip in the year ending in March 1989, compared to 3.9 percent over the comparable period ending March 1988. Recent experience suggests that once an inflationary spiral gets started here, it is really hard to root out. For instance, wage inflation still was *well* above four percent two years after the recession ended in 1982. In contrast, all the other inflation indexes had fallen more quickly.

How can these stress points be alleviated? A two-pronged attack is best. First, reduce the federal budget deficit. This would help us to live within our means and diminish our appetite for imported goods. It also would reduce our craving for foreign funds and produce lower interest rates. And, perhaps best of all, it would reduce

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excess demand and ease strains on our resources, thereby reducing inflationary pressures.

The second prong of attack would be on the inflation front. This means a monetary policy that continues to resist inflationary pressures, but works in concert with deficit reduction. In fact, with a declining deficit, it might even be possible to fight inflation with *declining* interest rates! This two-pronged approach would help to ensure a steady reduction in the economy's stress points.

Unfortunately, there is not a lot of reason to be optimistic about the timeliness of the first line of attack. One obstacle is that the Congressional Budget Office and the Office of Management and Budget cannot agree on how big the attack forces need to be. CBO is projecting deficits of \$125 billion or more through 1993, while OMB expects a small *surplus* by '93. This incredible disparity arises because OMB envisions a considerably more rosy path for economic growth and interest rates than CBO does.

CBO's outlook is likely to be closer to the mark. So, we need *big* cuts (or big revenue increases) to reduce the deficit. And because those are hard to come by, the Federal Reserve's battle will be more difficult. After all, the Fed does not have control over the federal budget deficit or any of the other "D-words." Its task is to resist the inflationary pressures they foster. The Fed has done this over most of the past two years. Since March 1988, in particular, the Fed has tightened policy in gradual, but steady, steps. From a starting point of six percent in early 1988, the Fed has raised the discount rate twice—to seven percent, as of February 24th of this year. Importantly, the federal funds rate (the rate on reserves banks lend to each other overnight) and other short-term interest rates have risen about three percentage points over this period.

But resisting current inflationary pressures is not enough. The Fed's goal is to *eliminate* inflation over the long haul. We are wasting precious resources if we have to use them to find ways to protect ourselves from the risk of price increases.

The Fed's goal of price stability is why it continues to reduce the target growth ranges for the broad monetary aggregates each year. For 1989, the Fed lowered both the upper and lower bounds of the growth range for the M2 measure

of money by one percentage point. The range is now three to seven percent.

Unfortunately, inflation does not give up ground quickly. It takes at least a year for a change in Fed policy to deal a measurable blow to inflation. So, the Fed's shift to a tighter policy last year should begin to produce results some time this year. And the effects of the Fed's most recent actions should be seen in 1990. This means that even if inflation continues to accelerate somewhat through the end of 1989, by the end of 1990, the trend in inflation should be downward once again. Of course, such a lag makes it harder to judge the appropriateness of a given policy stance, but I think we are on the right track currently.

So far, financial markets seem to agree. Long-term interest rates have not risen by anywhere near as much as short-term rates. For example, the 30-year Treasury bond rate has risen only 50 to 60 basis points since March 1988, while the 90-day Treasury bill rate has risen more than five times that amount. The widely-cited survey of financial decision makers by Drexel Burnham Lambert suggests that this flattening of the yield curve reflects a decline in long-run inflation expectations associated with the rise in short-term interest rates.

During past economic expansions, the Fed has been criticized for being a step or two slow in its counterattack on inflation. Inflation would tend to get out of hand, and only a serious economic contraction would bring it under control again. This time around, however, financial decision makers apparently believe that Fed action has been more timely. And I agree. We have a chance this time to curb inflation without an economic downturn.

Looking ahead

But just what *is* needed to keep inflation under control? With the economy operating at, or even above, its long-run capability to produce goods and services, we cannot afford GNP growth even as high as the rate of growth in that capability. Only slower growth will allow the *level* of activity over time to ease into a range that does not continue to stimulate excess demand pressures.

In recent years, the capability to produce goods and services probably has been growing at a rate of around 2½ percent a year. We could quibble about this particular benchmark, but the point is: if we want inflation to start yielding ground again, we must accept relatively slow economic growth. Moreover, because the economy has

been operating above full employment of labor and manufacturing capacity for some time now, slower growth for just a quarter or two probably will not be enough; reducing inflation significantly may take a prolonged period of growth at a pace below that of our long-run productive capability.

Because of the snail's pace of progress on the federal budget deficit, slower economic growth is going to mean slower spending in the private sector. Given this unpleasant tradeoff, some might ask, "what is wrong with a little inflation?" What is wrong is that a little inflation has a disturbing tendency to turn into a lot of inflation. The choice boils down to this: either we pay the price to deal with it now, or we wait until it has more momentum and requires a more forceful response.

If we are fortunate, past monetary restraint, including the Fed's most recent actions, may be enough to ease the economy into a more sustainable growth range. Even though growth in the first quarter was strong, at an annual rate of 5½ percent, that is not as worrisome as it might appear. Keep in mind that a whopping two and a half percentage points of the first quarter number represented an adjustment to the level of GNP by the Commerce Department to account for the (assumed) end of the drought in 1989. And for the remainder of this year, growth should be more moderate.

But the Fed will have to watch economic developments carefully in coming months. Evidence that the economy is not slowing significantly would signal continued upward pressure on prices. On the other hand, we must be careful that the economy does not slow too much. After all, recession comes with a high price tag, too. At the moment, the inflation risk definitely seems greater, but these opposing concerns do require a careful balancing act.

Inflation outlook

Inflation, as measured by the consumer price index, is likely to rise at a faster clip this year

than last year—not that double-digit inflation is in the offing, but a rise from 4¼ percent last year to about five percent (on a fourth quarter over fourth quarter basis) this year is quite likely. This forecast assumes that the drought moderates and agricultural production returns to more normal levels. If we get another year of drought—a distinct possibility in some regions, at least—inflation could be somewhat higher.

Also, if the dollar were to fall substantially, inflation could be considerably higher this year and next. A low dollar increases inflation by raising the price of imports and easing competitive pressure on domestic producers. Finally, the price of oil is another uncertainty in the inflation outlook—if it does not fall from its present high level, inflation will worsen.

Leaving aside movements in the dollar and food and energy prices—factors that largely are beyond the control of the Fed, anyway—the real concern should center on the strength of underlying wage pressures this year and next. It is here that a slowdown in the pace of economic activity will have the most impact on inflation over the long haul.

Wage pressures are likely to remain strong this year, largely because the economy is operating at such a high level. In coming months, there is reason to be hopeful that economic activity will slow somewhat. The Fed's recent actions should help in this regard. But we will have to scrutinize the signals on the pace of growth to tell if the economy cools off enough. If it does, wage and price inflation should start to yield ground once again.

Slow growth a boon

In the final analysis, then, recession in the U.S. is not likely this year. Certainly, slower growth is likely, but that is good news on the inflation front. And ultimately, that is good news for the longevity of our expansion.

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